

Service Date: April 5, 1990

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * * * *

IN THE MATTER of the Application)	UTILITY DIVISION
of MOUNTAIN WATER COMPANY for)	
Authority to Increase Rates and)	DOCKET NO. 89.6.23
Charges for Water Service in the)	
Missoula, Montana Service Area.)	ORDER NO. 5449a

FINAL ORDER

APPEARANCES

FOR THE APPLICANT:

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FOR THE INTERVENORS:

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FOR THE COMMISSION:

Robin McHugh, Staff Attorney, 2701 Prospect Avenue, Helena,
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Ron Woods, Rate Analyst, 2701 Prospect Avenue, Helena, Montana
59620

BEFORE:

HOWARD L. ELLIS, Commissioner and Hearing Examiner
DANNY OBERG, Commissioner
WALLACE W. "WALLY" MERCER, Commissioner

BACKGROUND

On June 29, 1989 Mountain Water Company (Applicant, Company or MWC) filed an application with the Public Service Commission (Commission) for authority to increase water rates and charges for its Missoula, Montana, customers on a permanent basis by approximately 17.68 percent. If granted, this would constitute a revenue increase of approximately \$804,241.

Concurrent with its filing for a permanent increase in rates MWC filed an application for an interim increase in rates of approximately 11.75 percent, equalling a revenue increase of approximately \$534,329 or 66.4 percent of the proposed permanent increase.

The Montana Consumer Counsel (MCC) and the City of Missoula intervened in this proceeding. The MCC actively participated in all phases of this Docket.

On September 27, 1989 MWC and the MCC entered into a stipulation that, for purposes of this rate case, a reasonable cost of equity would be 12.5 percent and a reasonable hypothetical capital structure would be 55 percent equity and 45 percent debt. The stipulation also provided that the debt component of the capital structure would be divided into two parts, 25.5 percent being the actual debt of the Company and 19.5 percent representing hypothetical debt.

The stipulation filed with the Commission contained a motion requesting that the Commission issue an order adopting the stipulation entered into by the Applicant and MCC. Before the

Commission will accept a stipulation disposing of a contested issue in a rate case it requires, 1) that the parties to the stipulation provide sufficient information for the Commission to conclude that the stipulation is reasonable, and 2) that all parties have an opportunity to comment on the stipulation.

On November 27, 1989, following notice to all parties in this Docket, a meeting was held in the Commission offices to discuss the reasonableness of the proposed stipulation. Representatives of MWC and the MCC were present at the meeting. The purpose of the meeting was to allow the Applicant and the MCC to provide the Commission with additional background information in support of the reasonableness of their stipulation and to receive comments from all parties.

On December 22, 1989 the Commission, having considered the merits of the Applicant's interim rate application and information presented on the reasonableness of the proposed stipulation, issued Order No. 5449. This order granted the Applicant interim rate relief in the amount of \$374,516 and adopted the proposed stipulation, for purposes of this Docket. Details of the Applicant's original proposal regarding capital structure and cost of equity as well as the stipulated proposal accepted by the Commission in Order No. 5449 will be discussed later in this order.

On January 30, 1990, following issuance of proper notice, a hearing was held in the City Council Chambers, City Hall, Missoula, Montana. For the convenience of the consuming public an

evening session was held January 30, 1990, at 7:00 p.m. at the same location. The purpose of the public hearing was to consider the merits of the Applicant's proposed water rate adjustments.

The year ending December 31, 1988 is the test year in this application. The Commission finds this to be a reasonable period within which to measure the Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for water service.

FINDINGS OF FACT

At the public hearing, the Applicant presented the testimony and exhibits of:

Lee Magone, Vice President & General Manager, MWC
Don Cox, Certified Public Accountant.

The MCC presented the testimony of one expert witness, Frank Buckley, Rate Analyst, Montana Consumer Counsel. No public testimony was received during either of the hearing sessions scheduled for January 30, 1990.

CAPITAL STRUCTURE

In its application MWC proposed the following capital structure for rate case presentation:

<u>Description</u>	<u>Amount</u>	<u>Ratio</u>
Equity	\$7,033,271	74.48%
Debt	<u>2,410,000</u>	<u>25.52%</u>
	\$9,443,271	100.00%

As part of the stipulation entered into between the Applicant and the MCC, the Applicant agreed to the use of a hypothetical capital structure to determine its composite cost of total capital. The Applicant and MCC agreed to the use of a 45/55 debt-equity ratio, with the hypothetical debt being assigned a current cost of attracting debt for MWC, for purposes of calculating the following capital structure:

<u>Description</u>	<u>Amount</u>	<u>Ratio</u>
Equity	\$5,188,299	55.00%
Debt 1	2,405,484	25.50%
Debt 2	<u>1,839,488</u>	<u>19.50%</u>
	\$9,443,271	100.00%

The Commission, for the reasons stated in its Order No. 5449, found that use of the stipulated capital structure as presented in Finding of Fact No. 13 is reasonable in this case. The stipulated capital structure will be used to calculate the composite cost of total capital in this Docket.

COST OF EQUITY

The Applicant originally requested that the Commission authorize a 13.0 percent return on equity. As part of the stipulation between the Applicant and MCC, the Applicant agreed to reduce its requested return on equity from 13.0 percent to 12.5 percent.

The stipulated return on equity was not a contested issue during the public hearing in this Docket. As indicated by the Findings of Fact in Order No. 5449, the stipulated return on equity

is within the range of the returns recently authorized by this Commission for other utilities under its jurisdiction. The 12.5 percent return on equity stipulated to by the Applicant and the MCC will be used in this order for purposes of determining MWC's composite cost of total capital.

COST OF DEBT

The actual debt capital (Debt 1) of the Applicant consists of a note issued by Park Water Company to Montana Power Company. This debt is an obligation of Park Water Company rather than its subsidiary, MWC, but the note has been properly assigned to the Applicant for ratemaking purposes.

The cost of debt, or interest, on this note is variable, the present cost being 9.25 percent and the cost at maturity being 10.0 percent. The cost of debt presented by the Applicant for this obligation was not challenged by any party participating in this proceeding and is accepted by the Commission.

The hypothetical debt (Debt 2) included in the Applicant's capital structure has been assigned a cost of 13.0 percent. This is the debt cost represented in the stipulation as MWC's current cost of attracting incremental debt. For the reasons discussed in Order No. 5449 the Commission, for purposes of this proceeding, has accepted this cost.

CAPITAL STRUCTURE AND COMPOSITE COST OF TOTAL CAPITAL

The Commission finds the following capital structure and composite cost of total capital to be reasonable:

<u>Description</u>	<u>Amount</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
Equity	\$5,188,299	55.0%	12.50%	6.875%
Debt 1	2,405,484	25.5%	9.25%	2.359%
Debt 2	<u>1,839,488</u>	<u>19.5%</u>	13.00%	<u>2.535%</u>
	\$8,984,414	100.0%		

Composite Cost of Total Capital 11.769%

FINDINGS OF FACT 12 THROUGH 20 ARE PRESENTED FOR INFORMATION PURPOSES ONLY. THE APPLICANT'S CAPITAL STRUCTURE AND COST OF CAPITAL WERE THE SUBJECT OF A SEPARATE COMMISSION ORDER.

RATE BASE

In its application MWC proposed an average original cost depreciated rate base of \$9,375,318. In prefiled direct testimony MCC's expert witness proposed four adjustments reducing the Applicant's proposed rate base by a total of \$199,710.

The Applicant's rebuttal testimony contested only one of the rate base adjustments proposed by the MCC. The Applicant contested MCC's proposal to exclude \$55,766 from rate base. The contested amount reflects the unamortized balance of service line expenses incurred by the Applicant in complying with Section 69-4-511, MCA.

For reasons that will be discussed fully in the operation and maintenance expense section of this order, the Commission finds that the Applicant's proposal to include in rate base the

unamortized balance of service line expenses should be denied. The Commission further finds the Applicant's original cost depreciated rate base is \$9,175,608.

OPERATING REVENUES

The Applicant in its Exhibit B proposed test period operating revenues of \$4,549,484. The test period operating revenues as calculated by the Applicant were not a contested issue in this Docket and are accepted by the Commission.

OPERATING EXPENSES

The Applicant in Exhibit B, proposed total test period operation and maintenance expenses of \$2,904,933. The test period operation and maintenance expense proposed by the Applicant includes proforma adjustments increasing expenses by \$209,191. Only those items of expense that remain a contested issue will be addressed in this section.

MCC's expert witness proposed adjustments increasing and decreasing the Applicant's proforma expenses. The net effect of MCC's proposed adjustments was to decrease proforma expenses by a total of \$196,665. Those adjustments proposed by MCC that were not rebutted by MWC are assumed to be accepted. The unrebutted items result in reductions to proforma operation and maintenance expense totalling \$75,166.

MWC in the rebuttal testimony of its witnesses (Exhibit Nos. C and D) framed the items of expense that were still in

dispute between the parties. The testimony indicates the following expense items remain in dispute:

- 1) Senate Bill 28 compliance costs
- 2) Rate case expense
- 3) Administrative overhead costs
- 4) Water sampling costs
- 5) Ground water contamination study costs
- 6) Allocated salary of two main office employees.

The Montana Legislature passed Senate Bill No. 28 during its 1987 legislative session. SB 28 is codified as 69-4-511, MCA.

For purposes of discussion in this order the term SB 28 will be used. SB 28 changed the responsibility for maintenance and repair of water service lines. Prior to October 1, 1987, the effective date of SB 28, the responsibility for repair and maintenance of the entire water service line from the water main to the premises of the consumer was the consumer's obligation. On October 1, 1987 it became the responsibility of the private water service provider to maintain and repair the portion of the water service line from the company's water main to the consumer's property line.

In testimony both MCC and MWC acknowledged that MWC had incurred expenses as a result of the legislated change in repair and maintenance responsibility. MCC and MWC disagree over the ratemaking treatment that should be afforded costs incurred in complying with SB 28 during the period 1/1/88 through 6/30/89.

In its filing MWC has proposed that SB 28 costs incurred during an 18 month period prior to the filing of this rate application be capitalized and recovered through a two year amortization. Although the Applicant, in the rebuttal testimony of

Mr. Magone, acknowledges that its proposal to recover the prior period SB 28 expenses represents a conflict with the general rule against retroactive ratemaking, the Applicant contends recovery should be allowed. The Applicant argues that the expense incurred in complying with the requirements of SB 28 represents a special circumstance that warrants departure from the Commission's general prohibition against retroactive ratemaking.

MCC opposes the Applicant's treatment and asserts that the Commission should not approve the Applicants's proposal to capitalize these costs and recover them over a two year amortization period. MCC alleges that allowing recovery of the service line maintenance expense incurred during the period 1/1/88 through 6/30/89 would represent retroactive ratemaking. MCC further contends that the \$111,533 in costs incurred by the Applicant in complying with the provisions of SB 28 have already been recovered from its ratepayers.

MWC contends that special circumstances dictate that the Commission should allow recovery of the prior period expenses in prospective rates. These special circumstances, according to MWC, include the following: 1) The Commission represented in United States District Court for the State of Montana, in litigation involving MWC and the Commission, that through the ratemaking process MWC would be compensated for money paid out to comply with SB 28 (Rebuttal Testimony of MWC witness E. Lee Magone, pp. 3-5, and MWC opening brief, pp. 3-4); and 2) The State of Montana imposed this cost on the Applicant and, therefore, it would be

unfair and unreasonable for the Commission to deny recovery of the cost of discharging the statutory obligation based on the general prohibition against retroactive ratemaking (Rebuttal testimony of Mr. Magone, p. 5).

MWC, through the testimony of Mr. Magone and in its opening brief, argues that the Commission committed itself to granting MWC's proposal in the briefs that the Commission submitted to the United States District Court.¹ MWC quotes the following language from the Commission's Brief in Support of Defendant's Motion for Summary Judgment, pp. 12-13, filed January 29, 1988:

There is no question that Mountain Water will incur certain operating expenses as a result of compliance with SB 28. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased. The PSC, for its part, will scrutinize all of Mountain Water's expenses to determine whether or not they are reasonable. Reasonable expenses will be added to a reasonable rate of return to arrive at the total amount of revenue (revenue requirement) that Mountain water will be allowed to recover through rates.

¹ MWC sought to have SB 28 declared unconstitutional in the United States District Court, Helena Division. As the enforcing agency the Commission defended the constitutionality of SB 28. Briefs were filed by both the Commission and MWC on simultaneous motions for summary judgment. On July 19, 1988 the Court granted the Commission's motion. That decision is presently on appeal.

MWC concludes from this language that, "The Commission specifically represented to the United States District Court that Mountain water would be compensated for the money it paid out under Section

69-4-511, MCA, through the ratemaking process" Rebuttal Testimony of E. Lee Magone, pp. 3-5. Such a conclusion is unwarranted. The language quoted from the Commission's brief merely constitutes a statement of the standard ratemaking process.

Standard ratemaking does not include the recovery of prior period expenses. Historic expense items, adjusted for known and measurable changes, form the basis for setting rates to recover expenses that will be incurred during the period rates will be in effect. Given the general rule against retroactive ratemaking, the Commission finds that the above language cannot reasonably be interpreted as a representation that past SB 28 expenses will be recovered. MWC has indicated it understands that rates are not normally set so as to ensure recovery of prior period, retroactive, expense. Therefore, MWC should understand that the above language carries no guarantee of the recovery of past expenses.

MWC also quotes from page 5 of the opinion of the District Court, dated July 19, 1988, that found SB 28 constitutional.

The PSC may regulate public utilities through powers granted by the Montana legislature. Mont. Code Ann. < 69-3-101 et. seq. The rates set by the PSC through its ratemaking policies must be at a level that allow a just compensation for any regulations imposed which impair the property in terests of the utility company. West Ohio Gas Co. v. Public Utilities Commission of Ohio, 294 U.S. 63 (1935). Compliance with the Act and the accompanying regulation will mean that MWC will incur additional operating expenses. These expenses will be a part of the data presented by MWC when applying to the PSC for additional rate increases.

The Commission is not clear why MWC refers to this language. In the Commission's opinion it is an accurate statement of the law and description of the ratemaking process. If MWC interprets this language as meaning that "just compensation for any regulations imposed which impair the property interests of the utility company" requires that the Commission allow recovery of prior period expenses, then such an interpretation is clearly in error. Just compensation in the utility ratemaking context means that rates must be set to allow the utility the ability to earn a reasonable return on the assets it devotes to utility service. If, in the opinion of the utility, due to increases in expenses (caused by government regulation or for any other reason), the utility cannot earn a reasonable return, it may apply to the Commission for rate relief. Upon a showing by the utility that it cannot earn a reasonable return the Commission will authorize rate relief. The rate relief authorized to the utility will be sufficient to recover costs that will be incurred during the period that rates will be in effect, as well as allowing the utility the opportunity to earn a reasonable return. To read into the Court's language an expectation by the Court that the Commission would allow retroactive recovery of SB 28 expenses is, in the Commission's judgment, without merit.

On page four of its opening brief MWC quoted from the Commission's Reply Brief in Support of Defendant's Motion for Summary Judgment, p. 8, filed March 31, 1988:

The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer no loss as a result of SB 28.

MWC then writes that its proposed ratemaking treatment for past SB 28 expenses "is in accordance with the Commission's representations to the federal court." First, the Commission finds that it did not represent by this language that it would apply a particular ratemaking treatment to SB 28 expenses upon the application of MWC.

Second, MWC's proposal is not to treat recurring SB 28 expenditures as capital cost, rather than expense. MWC expressly characterizes expenditures incurred as a result of SB 28 as expense and says that, "The Company proposes to capitalize the expenses incurred during 1988 and the first six months of 1989, and amortize those expenses over a 2 year period." Prefiled Direct Testimony of MWC witness Don Cox, p. 10. This proposal is not the same as proposing to treat SB 28 expenditures as capital cost. The Commission here issues an order based on the proposal that MWC made, not on a proposal that it might have made.

MWC argues at various places in its opening brief, and in the rebuttal testimony of Mr. Magone, that fairness and equity, if not traditional rules of ratemaking, support the recovery of past SB 28 expenses. Mr. Magone states,

It would be completely unfair and unreasonable for the State of Montana to impose upon Mountain Water the payment obligation specified in SB 28, then rely upon some general

ratemaking concept to deny Mountain Water the recovery of its cost of discharging its obligations under the statute Basic concepts of equity and fair play require the Commission to craft an exception to the general rule against retroactive ratemaking

Rebuttal Testimony of MWC witness E. Lee Magone, p. 5.

Ensuring utility recovery of costs and the generation of authorized rates of return are management responsibilities. Unlike unregulated business, regulated utilities cannot adjust prices at will to compensate for increased costs and decreased return. To compensate for increased costs and decreased earnings regulated utilities must apply to regulatory commissions to increase rates. Regulatory commissions set rates based on general principles of ratemaking that have been determined by statutory and constitutional requirements as interpreted by the regulators and the courts. It is, primarily, the responsibility of utility managers to assess utility earnings and determine when to request a rate increase. It is further the responsibility of a utility to know how the regulatory system functions and to use that system to maximum advantage. MWC knew in March of 1987 that SB 28 would take effect on October 1, 1987; yet, for reasons unknown to the Commission, MWC waited until June 29, 1989 to apply for rate relief that specifically included SB 28 expenses as a component of its revenue requirement. By contrast, the Butte Water Company, Montana's other major private water utility, filed an application with the Commission on June 17, 1987, more than three months before the SB 28 effective date, that included a proposal for recovery of

SB 28 expenses as a component of its rates. On February 22, 1988 the Butte Water Company, for both its Butte and Anaconda divisions, was authorized to file rates to reflect recovery of SB 28 expenses on a prospective basis. See Commission Order Nos. 5331 and 5332, Docket Nos. 87.6.30 and 87.6.31. The financial circumstances of MWC and Butte Water are different, and the Commission expresses no opinion on whether the ratemaking treatment for Butte Water SB 28 expenses would have been appropriate for MWC. The important point is that not until the summer of 1989 did the Commission have a proposal from MWC for treating SB 28 expenses as a component of its rates. And that proposal, if it were to be granted as filed, would force the Commission to violate a cardinal principle of ratemaking.

If MWC had made a different proposal at an earlier time it may have substantially recovered the expenses incurred from compliance with SB 28 without running afoul of the prohibition against retroactive ratemaking. MWC had a choice, both as to the timing and the details of its proposal. MWC must live with the consequences of its choice. The Commission finds that under the circumstances MWC's appeals to equity and fairness are misplaced.

MWC's proposal to recover prior period expenses of \$55,766, incurred as a result of compliance with SB 28 is denied. The reasons given by MWC to support its argument that the Commission should deviate from the rule against retroactive rate-making are not persuasive.

At the hearing the Applicant requested that it be allowed to update its SB 28 expense to the level actually incurred during

1989. MWC indicated that recurring SB 28 expenses reflected in the filing totalled \$74,355 but its 1989 experience was \$90,753. Given the significant variation in the expense levels the Applicant felt it appropriate to request the updating of the information.

The Applicant's request to update this expense item was not contested by any party. The Commission finds that in this instance it is acceptable to update the expense. Based on the preceding Findings of Fact concerning SB 28 the Commission finds that the Applicant's proforma expenses should be reduced by \$39,369.

MWC asserted that SB 28 expenses are not subject to the control of the utility and are expenses that are presently subject to significant variation. In support of this argument MWC drew the Commission's attention to the difference between the 1988 and 1989 expenses for this item. The Commission is persuaded by MWC that at the present time SB 28 expenses are volatile and not subject to the control of the utility.

Because of the volatility of the expense MWC proposed the implementation of a tracking mechanism for SB 28 expenses so that it could be assured that on a prospective basis it would be fully compensated for these costs. The Commission agrees in principle with MWC's proposal to implement a tracker. At the present time, however, MWC has provided insufficient information to the Commission to authorize its implementation. The Commission finds that the Applicant should make a tariff filing to be approved by the Commission, detailing its proposed tracking mechanism. This

tariff filing, to be consistent with others authorized by the Commission, should not recognize a time value of money.

Mr. Magone in his testimony implies that MWC did not recover through its test year rates the costs of discharging its obligation to comply with the requirements of SB 28. This statement is not supported by the facts in this case. When asked if MWC recovered all its costs of doing business during the test year, as well as earn a return on its investment, Mr. Magone replied affirmatively. Since all costs of doing business were recovered and a return on investment was earned, MWC did indeed, during the test year, recover costs incurred as a result of complying with SB 28.

Rate case expense was another of the disputed matters between the parties in this Docket. The Applicant proposed to recover in rates over a two year period \$100,980 in projected rate case expenses. The Applicant based its estimate on actual rate case expense incurred in preparing and presenting its 1986 general rate application to the Commission.

MCC's witness made a data request to the Applicant on the actual year-to-date rate case expense for this presentation. The Applicant responded that as of September, 1989 MWC had incurred \$25,224 in rate case expense. Based on this response, recognizing that the Applicant would incur additional costs before the completion of this rate case, the MCC's witness recommended a rate case expense of \$50,000 to be amortized over two years.

During cross-examination MWC witness Don Cox was asked if he could provide an updated actual rate case expense for MWC. Mr. Cox stated that as of the end of December, 1989 MWC had incurred \$37,491.17 in costs for preparing and presenting this rate application. Mr. Cox was also asked if, in his opinion, the expense for conducting this case would be as great as that incurred by MWC for its 1986 presentation. Mr. Cox responded that, barring prolonged litigation, he would guess that it would not be as expensive.

The Commission is not comfortable accepting either of the cost estimates presented for this item of expense. The MCC's estimate appears to understate the costs that will be incurred by the Applicant, and MWC's estimate appears to overstate the costs.

As of December, 1989 MWC had incurred actual rate case costs in excess of \$37,000. This cost was prior to MWC's preparation for the public hearing, participation in the public hearing, and briefing of issues in this Docket. All of these represent significant cost factors relative to the rate case presentation; therefore, in all probability rate case expense will exceed \$50,000.

MCC has elicited from the Applicant an admission that costs for preparing this rate case are lagging behind the costs incurred in preparing the 1986 rate case. This lends support to MCC's position that the costs to be recovered should be reduced.

Since neither party's estimate is clearly correct the Commission is placed in the position of having to make a subjective determination regarding the appropriate expense allowance. The Commission finds that a reasonable expense recovery for this item of expense is \$75,000.

To reflect the adjusted rate case expense the Commission finds that the Applicant's proforma expenses should be reduced by \$12,990 annually.

In his prefiled testimony Frank Buckley, the MCC's expert witness, proposed that the Applicant's payroll expense be reduced by \$260. Mr. Buckley stated that increases in general and administrative salary levels warranted the transfer of additional payroll expense to Construction Work In Progress (CWIP).

In his rebuttal testimony Mr. Cox stated that MWC's costs transferred to CWIP for administrative overhead are not contingent upon the salary levels of employees. Mr. Cox indicated that the amount of MWC administrative overhead transferred to CWIP was dependent on capital costs incurred and equalled 5 percent of the construction costs. He further stated that changes in payroll costs for general and administrative would have no affect on the amounts transferred to CWIP. Based on the testimony the Commission finds that the Applicant's payroll expense should not be reduced by \$260 as proposed by MCC.

No controversy surrounded the permissibility of MWC recovering costs incurred for water sampling or a ground water

contamination study. The dispute surrounding these issues centered on the appropriate amount to be recovered. The Applicant proposed to recover \$19,200 and \$17,920 for water sampling expense and the ground water contamination study, respectively.

MCC disagreed with the amounts proposed by the Applicant.

MCC, utilizing an annualization, determined that the Applicant should be authorized \$14,460 for water sampling costs and \$8,960 for the ground water contamination study.

At the hearing MWC cross-examined Mr. Buckley regarding his proposed adjustments to these items of expense. During this cross-examination the Applicant elicited a concession from Mr. Buckley that he would have no objection to MWC recovering the 1989 actual level of expenditure for these two items of expense.

The Commission finds that the Applicant should be allowed to recover \$14,020 for the ground water contamination study and \$18,313 in water sampling costs. The amounts accepted by the Commission represent a decrease from the amounts originally proposed by the Applicant. MWC's proforma expenses should be decreased by \$2,837 annually.

The last contested operating expense is the Applicant's proposal to recover an allocated portion of salaries and fringe benefits for two of Park Water Company's employees. Park Water Company is the parent of MWC and provides certain support services to MWC through its main office in Downey, California. MCC asserts that the aliquot portion of salaries and fringe benefits for Park

Water Company's Vice President - Investments and Acquisitions and Vice President - Policy, Planning and Rates, should not be recoverable from MWC ratepayers. Mr. Buckley, in his prefiled testimony stated that in his opinion these two positions "... have little, if anything, to do with or for Mountain Water Company."

MWC witness Mr. Magone, in his prefiled rebuttal testimony, opposed Mr. Buckley's view and indicated that these two positions did indeed provide tangible services to MWC. In his testimony Mr. Magone made the following statements regarding the Vice President - Policy, Planning and Rates, prior to his retirement:

Among other things, he was in charge of the Company's regulatory affairs, particularly the preparation and presentation of rate cases. Mr. Gallup was in charge of Mountain Water Company's preparation and presentation of its last case to this Commission, PSC Docket No. 86.9.51 ...

Mr. Gallup decided to retire in 1987 ... Mr. Gallup agreed to work part-time in 1988 in order to insure a smooth transition. As a result, the Company's 1988 test year cost of service includes the salary and fringe benefits paid Mr. Gallup in 1988. Those expenses are properly allocable to Mountain Water under the four factor allocation.

(Rebuttal Testimony of MWC witness E. Lee Magone, p. 11.)

In support of his contention that salary and fringe benefits of the Vice President - Investments and Acquisitions was properly recoverable from MWC ratepayers Mr. Magone stated the following at pages 12 and 13 of his prefiled rebuttal testimony.

That exhibit clearly establishes the services that the position provides to Mountain Water

Company. In addition to the general corporate duties, that position, which is held by Mr. Don Trevitt, is responsible for the management of the cash funds of Park Water Company and its subsidiaries, and the procurement of debt capital. The individual subsidiaries of Park Water Company, including Mountain Water, do not have their own finance and treasury departments. These functions are instead performed by Park Water Company on a centralized basis. Mountain Water, as does the other subsidiaries, forwards its cash balances to Park Water Company, which then manages the money and returns it to the subsidiaries when it is needed.

Mr. Buckley apparently believes, on the basis of the Company's response to PSC data request 7, that the procurement of debt capital by Mr. Trevitt provides no benefits to the Mountain Water Company, because no debt capital was actually issued in the name of Mountain Water during the test period. That theory is directly contradicted by this Commission's decision in Order No. 5449 entered in this docket on December 22, 1989. Specifically, the Commission found in Finding of Fact 8 of the Order:

Mountain Water Company is a wholly owned subsidiary of Park Water Company (Park Water). Park Water provides certain support service to MWC through its main office in Downey, California. One of the services provided to MWC, by Park Water, is financial management assistance. The main office financial management assistance includes the handling of any potential debt placement for Mountain and all other subsidiaries under Park's corporate umbrella.

Based upon that finding, the Commission held that in future rate cases the cost of hypothetical debt in a hypothetical capital structure for Mountain Water will be reflected at the cost of debt capital to the Park Water Company. It would be completely unreasonable and unfair for this Commission to capture in

Mountain Water's rates the favorable cost of debt that Park Water Company can obtain, then turn around and contend that the individual who obtains that favorable cost of debt for Park Water Company provides no useful services to Mountain Water.

Mr. Magone, on cross-examination, was asked questions regarding specific tasks and services performed by these two positions during the 1988 test year that provided benefit to MWC. Mr. Magone indicated that Mr. Gallup, who retired, came back essentially to work on rate cases filed by the parent and its subsidiaries. The following exchange between MCC and Mr. Magone took place during cross-examination regarding the Vice President - Policy and Planning position.

Q. Well, I understand that he was working for the Park Water Company. What I'm interested in is specific tasks that he performed or services that he provided to the Mountain Water Company during 1988?

A. I'm not really aware of them by name. I'm just not sure what he did.

Q. Did you have any contact directly with Mr. Gallup during 1988?

A. Perhaps, I don't recall.

Q. You don't recall whether you asked him to perform any services or do any work specifically for the Mountain Water Company?

A. No, ma'am, I do not.

Q. Did you review any work products of Mr. Gallup produced during 1988?

A. I don't think so.

Mr. Magone's answers are contrary to his assertion that it is appropriate to recover 23.75 percent of this position's

salary from MWC ratepayers. Mr. Magone states in his rebuttal testimony and on cross-examination that the primary job duties of this position are rate case related. But in the preceding exchange he cannot specifically recall reviewing any work products from the position, requesting the person holding the position to perform any services or work for MWC, or having any direct contact with the person holding the position. The Applicant was unable to show that this position, which is mainly rate case related, performed any beneficial functions for MWC during the test year. The Commission finds the Applicant's request to recover salary and fringes should be denied.

In regard to the Vice President - Investments and Acquisitions, Mr. Magone testified in prefiled rebuttal, and on cross-examination, that this individual did, in his opinion, provide services that directly benefited MWC. Mr. Magone testified that of eleven duties and responsibilities described in this position's job description, he could identify two that specifically benefited MWC; he indicated he had no specific knowledge of the remaining nine. The duties and responsibilities he identified as benefiting MWC were cash management duties and debt capital procurement.

Mr. Magone asserts that the debt capital procurement responsibility of this position produces a tangible benefit to MWC and its subscribers. He indicated that on a prospective basis the Commission intends to use the lower cost debt available to Park Water, to determine MWC's cost of hypothetical debt. He argued

that it would be unreasonable for the Commission to capture in MWC's rates the favorable cost of debt obtainable by Park Water, then turn around and disallow recovery of the allocated salary of the Park Water employee that obtains the debt because he provides no useful service to MWC.

In this Docket this argument has no merit. In determining the hypothetical cost of incremental debt for MWC, the Commission did not substitute the more favorable cost of debt obtainable by Park Water. Instead of substituting the more favorable rate, the Commission accepted the stipulated cost determined reasonable by MWC and MCC. This stipulated cost of debt assumed that MWC would be the entity obtaining the debt not the corporate parent; therefore, the cost of incremental debt determined for MWC reflects the cost at which MWC could attract debt, not the parent.

The cost of debt capital awarded MWC in this proceeding does not, as the Applicant represents, support the Applicant's contention that the salary and fringes of the Vice President - Investment and Acquisitions should be recoverable from MWC ratepayers.

On cross-examination by the PSC staff, Mr. Magone explained that MWC generated excess cash during certain periods when revenues exceeded expenses. He further explained MWC's excess cash is sent to the corporate office for investment. The management of the monies sent to corporate and invested by corporate are the responsibility of this position.

On cross-examination by MCC, Mr. Magone was asked if excess cash invested yielded income either through interest earnings or dividends. Mr. Magone indicated that he hoped so. When asked if income from interest earnings or dividends generated by investment of MWC excess cash was reported and considered as a regulatory revenue, he indicated he did not know.

In response to questions during the hearing, Mr. Magone stated that he presumed part of the excess cash available for investment by MWC was provided by ratepayers. He further indicated, that in his opinion, since part of the excess cash is provided by the ratepayers it would be appropriate that part of the interest earnings be reflected as benefiting the ratepayers.

Generally, for purposes of establishing rates, interest or dividends earned on short-term investments, such as investment of excess cash, is not reflected as regulatory revenue. The same treatment is afforded interest expense incurred on short-term borrowings, it is not reflected as a regulatory expense. From a regulatory perspective management of short-term investments or borrowings are not a consideration in ratemaking. The expense or revenue is presented below the line for ratemaking purposes, i.e., it does not impact the regulatory operating statement. Therefore, arguing that salary and fringes should be recoverable from ratepayers for performance of this function is not valid. For all the Commission knows, earnings on short-term investments could totally offset the salary and fringe requirements of this position for performance of this function.

of the 11 job duties and responsibilities outlined in the job description for this position the Applicant could not identify any functions performed that represent a tangible benefit to MWC ratepayers.

The Commission finds that the Applicant should be denied recovery of the salary and fringe benefit costs for the positions of Vice President - Policy, Planning and Rates and Vice President - Investments and Acquisitions. MWC's proforma expenses should be decreased by \$30,942 to reflect this disallowance.

Based on the preceding Findings of Fact proforma operation and maintenance expenses are found to be \$2,743,629, recognizing total proforma adjustments increasing expenses by \$47,886.

DEPRECIATION EXPENSE

The test period depreciation expense is not a contested issue in this Docket. The Applicant proposed depreciation expense of \$396,016, which is accepted by the Commission.

TAXES OTHER THAN INCOME

The Applicant proposed an expense for Taxes Other Than Income at present rates of \$324,028. The MCC's witness proposed adjustments decreasing this category of expense by \$5,901. The adjustments proposed by MCC's witness were not contested by the Applicant. The Commission finds Taxes Other Than Income to be \$318,127.

REVENUE REQUIREMENT

Based on the Findings of Fact contained herein, the Commission finds that in order to produce a rate of return of 11.769 percent on MWC's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of \$414,727 from its Missoula, Montana water utility.

Applicant's accepted test year proforma operating revenues, expenses and rate of return are summarized as follows:

RATE DESIGN

The Applicant's proposed rate design was not challenged by any party participating in this proceeding. The Commission's examination of the rate structure indicates that the Applicant has attempted to equitably distribute the cost of providing service to the various customer classifications and it is, therefore, accepted.

MISCELLANEOUS

In his prefiled testimony Mr. Buckley discusses what the Commission perceives to be a significant shortcoming in MWC rate presentations. Park Water, the parent company, does not directly assign many identifiable costs to the cost-causing division. Rather than assign costs directly, the parent relies, for the most part, on the four-factor allocation procedure, developed by the California Public Utilities Commission (CPUC), for recovery of main office common costs.

In this Commission's opinion Park Water is not following the directions provided in the four-factor allocation procedure accepted by the California Commission. The "Policy Statement on 4-Factor Method," prepared by the CPUC and provided the Commission staff during an audit, provides in part as follows:

Administrative and general expenses consist of both direct and indirect items of expense. The items applicable to specific operations are first segregated and assigned directly to operations. It is especially important that effective measures be taken to assure that as many of these expenses as possible are

assigned directly. The maintenance of time records is recommended as a basis for the direct assignment of salaries and related expenses of these employees who are engaged in work on more than one operation. (emphasis added).

In light of this Park Water's response to PSC data request 6 clearly shows that the company is not following the directions for proper utilization of the four-factor allocation. The failure to directly assign as many costs as possible poses a credible basis for challenging the appropriateness of the costs determined by Park Water through their application of the allocation procedure.

MWC/Park Water should in future rate cases before this Commission be prepared to show that it is directly assigning all costs possible to the cost-causing division. Continued use of the allocation procedure without assigning as many costs as possible directly could result in the Commission not accepting the allocation procedure.

In order to avoid any potential future conflicts regarding the appropriateness of the Company's allocation procedure the Company should commence a dialogue with the staff of the MCC and the Commission. This dialogue should be directed toward developing an allocation procedure that satisfies the Commission's concerns in this matter.

CONCLUSIONS OF LAW

1. The Applicant, Mountain Water Company, is a public utility as defined in Section 69-3-101, MCA. The Montana Public Service Commission properly exercises jurisdiction over Applicant's rates and service pursuant to Section 69-3-102, MCA.

2. The Commission has provided adequate public notice and an opportunity to be heard as required by Section 69-3-303, MCA, and Title 2, Chapter 4, MCA.

3. The rates and rate structure approved in this order are just and reasonable. Sections 69-3-201, and 69-3-330, MCA.

ORDER

NOW, THEREFORE, IT IS ORDERED THAT:

1. Mountain Water Company shall file rate schedules which reflect an increase in annual revenues of \$414,727 for its Missoula, Montana service areas. The increased revenues shall be generated by increasing rates and charges to all customer classifications as provided herein.

2. This rate increase is in lieu of and not in addition to the rate increase approved in Order No. 5449.

3. The rates approved herein shall not become effective until approved by the Commission.

4. The Commission authorizes Mountain Water Company to file a tariff detailing its proposed tracking mechanism for SB 28 expenses.

DONE IN OPEN SESSION at Helena, Montana, this 3rd day of April, 1990, by a vote of 3 - 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

HOWARD L. ELLIS, Vice Chairman

WALLACE W. "WALLY" MERCER, Commissioner

DANNY OBERG, Commissioner

ATTEST:

Ann Peck
Commission Secretary

(SEAL)

NOTE: Any interested party may request that the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. See ARM 38.2.4806.